Online Accounting Software

FUNDING OPTIONS GUIDE

Why you need to think about funding

Every business needs money. Starting a business presents new challenges, many of which will require some financial outlay. You may need somewhere to work from, equipment, stock, staff, advertising and a website. Once your company is up and running you'll need to have enough cash to pay staff wages and suppliers on time. If you want to expand, you'll probably need even more funds.

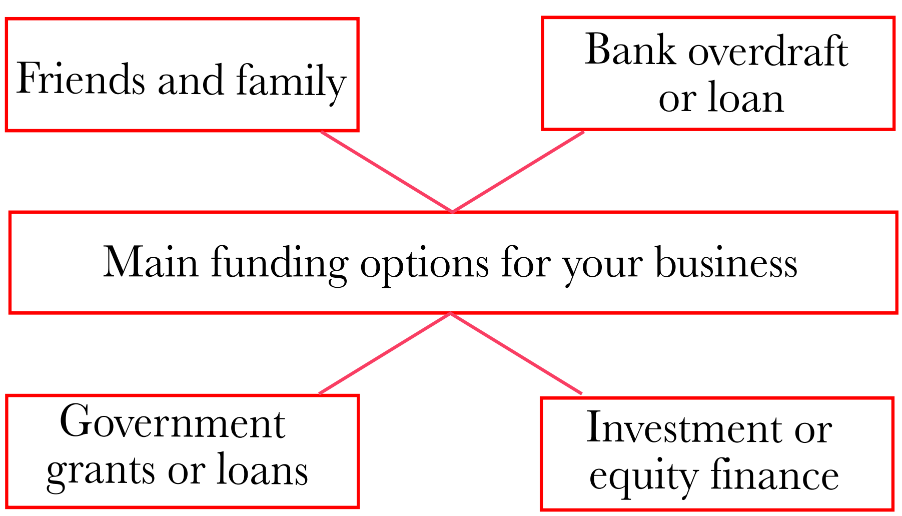
So, if you're faced with these challenges and you don't have huge savings or haven't been lucky enough to win the Lottery, how do you get your hands on funding – and what are the pitfalls? The first step is finding the most suitable option for you.

Factors to consider:

- how much funding you need
- when you need the financing and how your requirements might change over time
- how much money your business makes – or might make if it's a start-up
- the business or personal assets you're prepared to offer as security
- whether or not you're willing to share ownership of the business with someone else

With the exception of equity funding – which entails selling shares, i.e. part ownership of your company – most funding options involve borrowing money in some form or other. You might use just one or a combination of these sources of funding but it's important you know what you're getting into with each.

Main funding options for your business



Friends and family

Start-ups often get going with cash loans from friends and/or relatives: it's the quickest and easiest way to get funding. Rather than just lend you the money, it's quite common for friends or family to make loans in return for equity/shares, i.e. a stake in your company. Sometimes this means they'll want a say in how the company is run.

Friends and family: pros and cons

There's minimal red tape as friends or relatives will often 'take you at your word' without any formal agreement. However, drawing up an agreement is best practice as it might prevent agreements in the future. In addition, loans from pals or family usually come at a low interest rate – or even no interest at all!

Not setting up formal agreements over loans and/or dividing up shares has the potential to cause disputes if things go wrong. And, remember, more than money is at stake with friends or family – your relationship with them can be affected if the business doesn't perform well.

Banks and other financial institutions

Although there are different kinds of financial institutions that will lend money, banks are where most companies go looking for funding. If your only dealings with banks have been drawing your salary and paying bills through direct debits, it's easy to forget that lending is what banks are actually there for.

Because lending money is their specialty banks have lots of different ways of doing it. Get them to explain all their services and products – they'll happily offer their knowledge and expertise for free – to work out what your options are. And, remember, they're in competition with all the other banks, so don't just go with the first offer you get – there could be better terms and conditions just down the high street.

You'll most likely be discussing overdrafts, loans, invoice finance or leasing and asset finance. All of them come with arrangement fees and interest charges. And because the bank is taking the risk in lending you money, there will be other strings attached to the loan. In other words, the bank will want some security against your company failing – at which time certain assets of the business, or even personal assets like your home could be transferred to the bank's ownership. If you've been asked for a personal guarantee, this is not something to be given lightly. Think long and hard about giving it.

Overdraft

This is the most common bank loan and simply involves extending a line of credit which allows a business to take out more money than it has in its existing bank account, to an agreed maximum. An overdraft is a short-term funding option – credit 'facility' as opposed to a fixed loan. This means that an overall limit is agreed but that interest is charged only on the amount of any overdrawn balance. This flexible form of small loan can, for example, help a business with a 'cash-flow problem', i.e. it can be used to pay for something it urgently needs but can't purchase because it takes time for customers to pay their bills.

Overdraft: pros and cons

The advantages of overdrafts include their flexibility – you only borrow what you need, they're quick to arrange and you normally won't be charged for paying off your overdraft earlier than expected.

The disadvantages include: charges for going over your overdraft limit; the possibility that the bank may ask for its money back at any time; and the fact that you can usually only get an overdraft from the bank you hold your business current account with. Banks typically charge a higher interest rate for overdrafts than for medium to long-term bank loans.

Loans

Best used when there's a thought-out plan to invest in something of significant cost to get the company started or move it forward – perhaps to buy premises or expensive equipment. Just like a bank loan you might use to buy a car, you'll be expected to pay back the money, plus interest of course, in monthly instalments. Interest on the loan will depend on how long you need the loan for, how much you borrow and other factors, for example the European Central Bank base rate.

However, banks are not supposed to make loans without making sure they're a safe bet. This is where your business plan comes in (see our separate guide to business plans here). You will need to show:

- that your business is performing well, or has the potential to do well
- that you and your team, if you have one, know how to run the business successfully
- exactly what the loan is for and that you can repay it
- what security you can put up against the loan

Loans: pros and cons

The banks' attitude to lending has changed as a result of the financial crisis and the last recession. Before the recession, the banks were more generous about lending money, but recently have become very cautious. The lesson to be learned is that timing can be key: you need to keep an eye on what's going on in the wider economy.

The advantage of a loan is that it is repayable under set criteria – usually this means you can draw down all the money at the start and repay the bank monthly by way of principal and interest repayments. Loans can be tied to the lifetime of equipment or other assets you're borrowing the money to pay for and you don't have to give the lender a percentage of your profits or a share in your company. However, loans aren't very flexible. For example, you may have to pay charges if you repay early. Payments have to be made monthly and you might struggle if your customers don't pay you on time. Finally, if your loan is secured against your home, you could lose it if you don't keep up the loan repayments.

Invoice finance

To help with cash flow, banks or other financial institutions will agree to advance you 80-90% of the value of invoices you have sent but which your customers have not yet paid. Sometimes, the lender will even collect the money on your behalf, which is called factoring or debt factoring.

Pros and cons

Invoice financing will give your cash flow a boost and your customers don't have to know that you're borrowing against their invoices. If you use factoring, you'll have more time to run your business while your lender chases customers for payment. However, there is a cost for this because you have to pay the lender interest and other fees and this will eat into your profits.

Leasing and asset finance

This is a form of funding that involves your company leasing or renting assets, for example, very expensive but crucial equipment like the company's IT systems or fleet of vehicles. This can save you the initial costs of buying them outright and spread the payment over an agreed amount of time.

Pros and cons

You'll have access to equipment that you might not otherwise have been able to afford and interest rates on monthly instalments are usually fixed. If you can't make repayments the asset will be repossessed – you won't own it until the finance loan has been paid in full. Also, the leasing company must repair or replace the equipment if it breaks down. On the downside, in the long run it will work out to be more expensive than buying the equipment outright.

Credit cards

Useful as a means to provide quick and easy funding for the less expensive business costs, but unless you're able to repay the balance in full at the end of each month, the interest rates rapidly overtake those available through an overdraft or loan. This is generally a no-no for serious, long-term business funding.

Government grants and loans

In certain special circumstances, grants of taxpayers' money are given to businesses by the government or local government and many of their institutions. This might be to support and encourage companies in a particular business sector or region. Grants are also available from the European Union and charities.

Pros and cons

Your company won't have to pay a grant back, but there's a lot of competition for them and they are usually awarded for a very specific purpose so you'll need to find a grant that you qualify for. The application process can be time-consuming and while the grant might cover part of your costs you'll probably have to fund some of it yourself.

Investment or equity finance

If you've ever seen the Dragons' Den TV show, you'll understand that this involves giving away a part, or share, of your business (hence the term shares) to an investor. In return, the investor will share any profits and losses that the company makes.

There are several different types of investor in private companies. Venture capital companies will usually get involved, at an early stage, with a smaller business that they believe has a product or service with promise and that has the potential to become a big success and, they hope, deliver high rewards. If you aim to expand quickly and need a larger cash injection, venture capital might be for you.

So-called business angels are investors of the kind seen on Dragons Den. They're usually wealthy individuals, often entrepreneurs in their own right, who provide funding for start-ups. Typically their investment will be from €10,000 to €500,000. If you want to grow your business in a timescale with less pressure, this is the sort of investor that might work best for you. A small but increasing number of angel investors now organise themselves into angel groups or networks to share research and pool their investment capital.

Private equity firms will more likely invest in your company if it is a more established business that wants to expand to new markets by building new premises overseas or buying out another company.

The newest investment vehicle is crowdfunding, which involves a number of people each investing, lending or contributing smaller amounts of money to your business or idea. The money is then pooled to reach your funding target. Crowdfunding can not only raise finance relatively quickly, often without upfront fees, it can also raise awareness of your new business. Crowdfunding can also help create a business by setting up a book of pre-orders.

Investment or equity finance: pros and cons

Investors can bring new skills and opportunities to your business, for example knowledge of marketing techniques or exporting to overseas markets. There's no interest on the money you receive from selling equity and it's not a loan that you have to repay. You share the risks of the business with your investors.

On the downside, persuading someone to invest in your company can be a demanding and time-consuming process, and of course you'll own a smaller share of your business – although your share could eventually be worth more money if your business succeeds. Usually, your investors will want a say in business decisions, which can be a big adjustment if you've been used to making all the decisions yourself. And, remember, only limited companies can sell shares, so you can't raise money in this way if you're a sole trader or in a partnership. With crowdfunding, any money you raise will normally be returned to investors or contributors if you don't reach your funding target.

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Big Red Cloud is a leading supplier of online account's software to the SME market.

Our online account's software is simple and easy to use and takes only minutes to set up. It is designed to enable smart business people get on with doing what they do best which is to sell their products or services.

We believe in giving exceptional value by including multiple users, unlimited transactions, telephone, email, live chat support and free access for your accountant and bookkeeper, all for a low monthly fee.

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